Supreme Court, U.S.
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No. 98-1967

In The

Supreme Court of the United States

F. W. WOOLWORTH CO. and
KINNEY SHOE CORPORATION,

Petitioners,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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INTRODUCTION

Respondent Franchise Tax Board acknowledges that interest offset reduces a nondomiciliary's (but only a nondomiciliary's) interest expense deduction by exactly the amount of its constitutionally nontaxable income. It tries to avoid the constitutional implications of this by denying that interest offset is a tax and denying that discrimination by domicile is the proper focus of the constitutional analysis. The Board's arguments merely confirm the constitutional frailty of the statute and the need for this Court's review.

ARGUMENT

I. THE COURT SHOULD GRANT CERTIORARI TO DECIDE WHETHER INTEREST OFFSET VIOLATES DUE PROCESS

The Board concedes that "the dividends Woolworth received from its nonunitary foreign subsidiaries constituted nonbusiness dividend income that is immune from taxation by California," and that Woolworth's total interest expense deduction was "limited" by this constitutionally tax-immune income. Opp. 5, 23. And it does not deny that the net effect was the same as a direct tax on that income. Thus, the only issue is whether this satisfies due process.

To avoid the due process constraints on California's ability to reach Woolworth's dividend income, the Board argues that interest offset is a rational method of matching interest expense with the income it generates.

Opp. 14. This novel approach to due process fails to save interest offset.

A. As A Matter Of California Statutory Law, Interest Offset Does Not Match Interest Expenses And Dividend Income From Nondomiciliaries

The Board argues that interest offset is an "ordering rule" that "assigns" interest expense to the income it generates, and that "a state bears no obligation to allow a deduction for an expense *relating* to dividend income which that state is barred from taxing." Opp. 8 (emphasis added). To support this argument the Board relies on this Court's cases holding that statutorily tax-exempt income may be taxed up to its *fair* share of *related* expenses. Opp. 12-14. The Board's description of interest offset is false, and therefore its legal proposition and citations are irrelevant.

California Revenue & Taxation Code section 24425 expressly excludes from the measure of tax "any amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax imposed." *See Great Western Fin. Corp. v. Franchise Tax Bd.*, 479 P.2d 993, 995-96 (Cal. 1971) (holding that section 24425 disallows deduction of expenses used to produce dividend income that is not taxable). As a result, interest offset applies only to *business* interest expense, which, by definition, is *not* related to nonunitary dividend income.

Despite its pleas to consider the "overall context" of California's tax scheme, *see, e.g.*, Opp. 7, 22, the Board fails to mention section 24425, even once. This is a telling

omission given that section 24425 does exactly what the Board contends interest offset is trying to do.

Instead, the Board attacks Woolworth's citation of a schedule to the California Franchise Tax Return – on which the tax is actually paid. According to the Board, the form is "ambiguous," and "[i]t is the statute that governs the proper calculation of interest offset" "[e]ven if the tax form suggests otherwise." Opp. 15. However, even if the statute controls, the tax form and section 24425 are in perfect harmony: both exclude "nonbusiness interest expense" from the interest offset computation.

Moreover, even if interest offset somehow did involve nonbusiness interest expense used for investment, the Board admits that the statute makes no attempt to apportion or match dividend income against the interest expense incurred to produce the income. Opp. 16 (disclaiming any attempt to trace funds). Indeed, as the Board concedes, interest offset allocates *all* of the interest expense to the constitutionally tax-immune income, *dollar-for-dollar*, until one of the two is gone, without any inquiry into whether there was any relationship between the two. Opp. 3. That is anything but apportionment.

Accordingly, the Board's reliance on the "fair share" principle is misplaced. First, the "fair share" principle has never been applied to constitutionally nontaxable (as opposed to statutorily tax-exempt) income. Pet. 19 n.11. None of the Board's four cases was a due process challenge based on a lack of nexus between the taxing body and the income taxed. Three, *United States v. Atlas Life Insurance Co.*, 381 U.S. 233, 239-40 (1965), *Helvering v.*

Independent Life Insurance Co., 292 U.S. 371, 377-78 (1934), and *Denman v. Slayton*, 282 U.S. 514, 518-19 (1931), involved a federal tax; the fourth, *First National Bank v. Bartow County Board*, 470 U.S. 583, 585-86 (1985), involved a Georgia tax of a Georgia bank's property.

Second, even if the cases were on point, they do not support the constitutionality of interest offset because each case involved a properly apportioned tax. *First National*, 470 U.S. at 593 (relying on "fair share" of burden); *Atlas Life*, 381 U.S. at 247, 251 (noting proper allocation); *Independent Life*, 292 U.S. at 380 (relying on statutory apportionment); *Denman*, 282 U.S. at 519 (finding fairly imposed tax on "just share").

In contrast, interest offset utterly fails to apportion, such that a nondomiciliary multistate company is denied a deduction of interest expenses in an amount identical to its constitutionally immune income – regardless whether 100%, 50% or 0% of its interest expense was related to generating the income. This is simply arbitrary, the opposite of the "fair share" apportionment that the Court has upheld in the past.

B. The Board's "Money Is Fungible" Argument Has No Place In A Constitutional Analysis

Forced to acknowledge that interest offset makes no attempt to match interest expense with dividend income, the Board tries to excuse the failure by arguing that "money remains fungible." Opp. 9, 16. The significance of this fungibility apparently is that California need not apportion "a multi-state unitary business's interest expense between sources within California and sources

without the state." Opp. 17. According to the Board, section 24344 is good enough for due process purposes because it is "a rational legislative solution to [ ] serious administrative difficulties." *Id.*

This rationality test is not sufficient. First, as discussed above, the effect of section 24425 makes it *not* rational to assume *any* connection between interest expense and nonbusiness dividend income.

Second, the Board's argument that "money is fungible," thus making it "administratively overburdensome" to apportion the offset, Opp. 16, is disingenuous and inconsistent with other California tax statutes and regulations. Indeed, although the Board does not acknowledge its existence, section 24425 mandates the very apportionment that the Board says is too difficult. *See also, e.g.*, 18 Cal. Code Reg. §§ 24344(c)(3), (4) & (5) (making appropriate allocation); 18 Cal. Code Reg. § 25120(d) (requiring deduction to be "fairly distribute[d]" among business and nonbusiness income).

II. CERTIORARI SHOULD BE GRANTED TO DECIDE WHETHER INTEREST OFFSET VIOLATES THE COMMERCE CLAUSE

Woolworth proved that interest offset discriminates against interstate commerce by reducing the available tax deduction only when dividends are received by non-California domiciliaries from sources operating

outside California. Pet. 6-9, 21-26. The Board cannot deny this discrimination.[1]

Instead, the Board tries to avoid the Commerce Clause violation by proclaiming that "[t]he pertinent focus is not the effect that interest offset has on domiciliary corporations versus nondomiciliary corporations . . . . " Opp. 19. In fact, that is precisely the focus for Commerce Clause purposes, as this Court has held time and again. *See, e.g., Associated Indus. v. Lohman*, 511 U.S. 641, 654 (1994) ("[W]e repeatedly have focused our Commerce Clause analysis on whether a challenged scheme is discriminatory in 'effect.' "). That should be dispositive.[2]

The Board, however, suggests that the proper focus is "whether there is internal consistency if [the challenged tax] scheme were applied by every jurisdiction." Opp. 19-20. This is not correct. First, internal consistency is

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[1] The Board does not dispute (or even mention) the simple examples in the table on pages 7-8 of the Petition. This table clearly demonstrates the discriminatory effect of interest offset. Instead, the Board argues that interest offset "does not *provide for* disparate treatment" based on domicile, and that interest offset affects all multistate companies equally. Opp. 21-22 (emphasis added). But whether the discrimination is in the statute's terms or in its effect, the Commerce Clause violation is clear. Pet. 6-9, 21-26. Even if the statute does not say so, only domiciliaries can take advantage of the tax deduction offered by the last step of interest offset. Pet. 23-24. The deduction has nothing to do with the "character of the income." Opp. 21.

[2] Moreover, the Board's repeated reliance on the purported reasonableness of the statute is irrelevant for a Commerce Clause analysis, which subjects discriminatory taxes to "the strictest scrutiny." *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 101 (1994).

not determinative of compliance with the Commerce Clause. *See Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983) (calling internal consistency "*the first*, and again obvious, component of fairness in an apportionment formula") (italics added). A tax provision that is internally consistent thus still may violate the Commerce Clause. *Id.* at 169-70 (describing external consistency as "second and more difficult requirement" of Commerce Clause apportionment test). Indeed, the Court never even mentioned internal consistency in several recent decisions invalidating discriminatory state tax statutes. *See, e.g., South Central Bell Tel. Co. v. Franchise Tax Bd.*, 119 S. Ct. 1180 (U.S. 1999); *Camps Newfound/ Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997); *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

Second, interest offset fails even the internal consistency test. A tax is internally consistent only if its adoption by every state would cause "no impermissible interference with free trade." *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644 (1984). If every state applied interest offset, however, interstate commerce would suffer. Multistate businesses like Woolworth would bear a much higher tax burden than would wholly intrastate businesses. As more states indirectly taxed Woolworth's nontaxable dividend income through interest offset, Woolworth would be subjected to multiple taxation of the same income, income that is properly taxable only in New York, as the Board concedes. Opp. 5.[3] An intrastate company would be

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[3] The Board claims that New York will recognize the interest expense deduction that California denied and reduce Woolworth's New York taxable income accordingly. Opp. 23. There is no basis whatever for this assertion.

unaffected. Indeed, the clear detriment Woolworth suffers from interest offset in California would be multiplied every time another state applied the same rule. This failure of internal consistency "shows as a matter of law that [California] is attempting to take more than its fair share of taxes from the interstate transaction." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).[4]

Regardless of the test used to determine whether interest offset violates the Commerce Clause, the outcome is the same. Interest offset discriminates against interstate commerce. It must be struck down.

III. THE COURT SHOULD GRANT CERTIORARI TO DECIDE WHETHER INTEREST OFFSET VIOLATES THE EQUAL PROTECTION CLAUSE

Interest offset gives domiciliaries an interest expense deduction that it denies to nondomiciliaries. Pet. 26-28. The Board neither disputes nor justifies this discrimination. Its reliance on the California Legislature's freedom to classify taxes as it sees fit is insufficient, even under rational basis review, for two reasons. The statute is not rationally related to a legitimate state interest because (1) its protectionist purpose is not legitimate, *see*

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[4] The Board argues that internal consistency is satisfied because Woolworth would be entitled to its full interest expense deduction if every state applied interest offset. Opp. 22. That misstates the test. In fact, there is no internal consistency because Woolworth would be taxed repeatedly on more than 100% of its tax base whereas an intrastate corporation would not.

Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 876-78 (1985), and (2) it is not rationally related to the stated purpose because the supposed "tax loophole" does not exist. *See Western & S. Life Ins. Co. v. State Bd. of Equalization*, 451 U.S. 648, 668 (1981); *Williams v. Vermont*, 472 U.S. 14, 23 (1985) (striking down tax because "[a] State may not treat those within its borders unequally solely on the basis of their different residences or States of incorporation").

The Court should grant the writ to decide whether interest offset violates the Equal Protection Clause.

IV. THE IMPORTANT QUESTIONS PRESENTED REQUIRE THIS COURT'S GUIDANCE

The parties agree on the operation and effect of interest offset – and that it takes into account constitutionally nontaxable income to increase Woolworth's franchise tax. The only dispute, ripe for this Court's review, is whether interest offset survives constitutional scrutiny.

Nevertheless, the Board says the constitutional issues "lack national import or significance." Opp. 6. But the Board does not repudiate what it told the Court of Appeal: "[t]he constitutionality of [interest offset] is of great significance to taxpayers and the state." 1/4/99 letter from Bill Lockyer, Cal. Attorney General, to Court of Appeal. The constitutionality of the statute *is* of great national significance. This Court should grant review.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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